



DEVOLUTION OF FUNDS RESEARCH REPORT

FINANCE AND INVESTMENT CELL
SHRI RAM COLLEGE OF COMMERCE

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ABSTRACT:

The report examines India's tax devolution with special reference to vertical and horizontal fiscal resource distribution between the Union and state governments. Based on the equity, performance, and need principles, it analyses the extent to which the Finance Commission designs tax-sharing arrangements. It examines historical and modern approaches, economic and social determinants, and funding allocation factors that affect tax devolution. Issues pertinent to horizontal and vertical imbalances, GST, and the role of the Constitution are discussed. Backed by GDP and poverty data, HDI, and previous Finance Commission recommendations, the report seeks to evaluate the efficiency of existing devolution practices and make informed recommendations to attain fiscal equity among states.

INTRODUCTION:

Tax devolution is at the core of India's fiscal federalism, with a view to fair financial transfer from the Centre to the states. In a quasi-federal system, the Finance Commission plays an important role in removing vertical imbalances (between states and the Centre) and horizontal imbalances (among states) by proposing tax-sharing ratios based on socio-economic factors such as income, population, and development requirements. This paper examines the history of tax devolution, why and how allocation criteria have been modified, and constitutional provisions governing it. It seeks to evaluate how well tax devolution leads to fiscal balance and equality among Indian states.

RESEARCH OBJECTIVE:

This research will investigate the notion and significance of tax devolution within Indian fiscal federalism, with a particular emphasis on the role of the Finance Commission in facilitating financial resource distribution between states equitably. It reviews past and present approaches to vertical and horizontal tax devolution, and identifies the social parameters such as GDP, poverty level, literacy, and HDI that drive inter-state allocations. The study also analyses the performance of previous devolution formulas in bridging regional inequalities. It also examines problems such as fiscal imbalance and the effect of GST, providing evidence-based suggestions to enhance the equity and efficiency of the devolution process.

RESEARCH METHODOLOGY:

Mixed-Method Approach: The study employs a mixed-method research strategy, integrating both qualitative and quantitative methodologies to holistically examine the devolution of taxes in India.

Secondary Data Sources: Data was sourced from authoritative secondary sources such as Finance Commission reports, RBI publications, government databases, and relevant academic literature to ensure reliability and depth.

Quantitative Variables: Key quantitative indicators like state-wise GDP, per capita income, literacy rates, poverty levels, and Human Development Index (HDI) were analysed to understand interstate disparities and the impact of tax devolution .

Advanced Statistical Analysis: Regression analysis was used to evaluate the correlation between devolution and socioeconomic indicators, while the Gini coefficient was employed to measure inequality in the distribution of devolved resources among states.

Historical and Institutional Insights: A thorough review of past Finance Commission recommendations was conducted to trace the evolution of the devolution formula, enriching the empirical analysis with institutional and theoretical perspectives.

DEVOLUTION OF FUNDS

INTRODUCTION

Devolution of funds refers to the constitutional mandate of sharing central tax revenues with state governments. This differs fundamentally from grants-in-aid or other discretionary transfers as it is an inherent right of the states, not a privilege. The process operates through a sophisticated mechanism governed by Article 280 of the Indian Constitution and is orchestrated through the recommendations of the Finance Commission.

The devolution framework encompasses two distinct dimensions:

1. Vertical devolution: Distribution between the Centre and the states collectively
2. Horizontal devolution: Distribution among individual states based on predetermined criteria

CONSTITUTIONAL PROVISIONS

The Indian Constitution provides an elaborate framework for revenue sharing through multiple provisions:

Article 270: Defines taxes levied and collected by the Union to be distributed between the Union and the States

Article 271: Allows surcharges on certain duties and taxes for Union purposes

Article 272: Permits Union excise duties to be shared

Article 275: Provides for grants from the Union to certain States

Article 280: Establishes the Finance Commission and its role

TECHNICAL ASPECTS OF DEVOLUTION OF FUNDS:

The devolution mechanism operates through:

1. Divisible Pool

- Consists of all central taxes and duties
- Excludes surcharges and cesses
- Includes corporate tax, income tax, GST, and customs duties

2. Transfer Mechanisms

- Statutory transfers through the Finance Commission
- Plan transfers (historically through the Planning Commission)
- Discretionary transfers through ministries

THE NEED FOR DEVOLUTION:

3 Key Points:

1. Addressing Structural Fiscal Imbalances

Devolution plays a critical role in addressing the inherent fiscal imbalances within India's constitutional framework. Vertical imbalances arise because the central government holds greater taxation authority, covering high-revenue sources, while state governments are tasked with delivering essential public services in sectors like education, healthcare, and agriculture.

This creates a gap between the states' revenue-generation capacity and their expenditure, undermining their ability to fulfil development goals. Devolution ensures that states receive adequate resources to maintain fiscal sustainability, improve administrative efficiency, and deliver public services efficiently. Additionally, horizontal imbalances caused by disparities between states, such as differences in per capita income, industrial growth, infrastructure, and natural resources, are also addressed.

2. Ensuring Equitable Development:

Devolution is key to achieving balanced regional growth and addressing developmental disparities. It facilitates the redistribution of resources from economically developed regions to those that are underdeveloped, ensuring support for backwards areas and offering special assistance to regions facing geographical challenges like mountainous terrain or areas prone to natural disasters.

It promotes infrastructure projects, industrial growth, and social sector improvements while also safeguarding environmental sustainability. Devolution enhances social equity by guaranteeing minimum standards of basic services, ensuring universal access to education and healthcare. Welfare programs targeting poverty reduction, social security, and equitable access to education and healthcare further reinforce this equity.

3. Economic Efficiency and Autonomy:

Devolution enhances economic efficiency by empowering local governments with fiscal autonomy, enabling them to independently allocate resources, set development priorities, and implement innovative solutions.

This flexibility allows governments closer to the people to address local needs effectively, ensuring better resource utilisation and stronger accountability mechanisms.

Administrative efficiency improves as local governments can conduct more accurate assessments and deliver services accordingly.

Additionally, devolution helps stimulate economic growth by promoting investments in infrastructure and promoting industrialisation. It also strengthens the local markets and facilitates trade. Together, these measures boost local economies and help in promoting the overall economic growth of the nation.

VERTICAL DEVOLUTION OF TAXES

Vertical Devolution refers to the distribution of net proceeds of taxes (Total tax revenue) between the Union and the States.

- As per Article 280 of the Indian Constitution, the Finance Commission of India makes recommendations about the Vertical Devolution of Taxes in the country.
- The share of states in the central taxes for the 2021-26 period is recommended to be 41%, the same as that for 2020-21.
- This is less than the 42% share recommended by the 14th Finance Commission for the 2015-20 period.
- The adjustment of 1% is to provide for the newly formed union territories of Jammu and Kashmir and Ladakh from the resources of the centre.

HORIZONTAL DEVOLUTION OF FUNDS

Horizontal Devolution is the sharing of tax revenue among various states of the country. (From the proportion of proceeds set aside for states by the Finance Commission.)

- 1.Horizontal Devolution of taxes is based on a variety of factors, including :
- Income- Inversely Related

• Population-Directly Related

• Area-Directly Related

• Forest and Ecology- Directly Related

• Demographic Performance-Directly Related

• Tax Effort-Directly Related

2.The recent trends in factors determining horizontal devolution of taxes can be understood from the attached table :

Table 1 : The criteria for horizontal devolution among States over the last five FCs

Criteria	11th FC 2000-05	12th FC 2005-10	13th FC 2010-15	14th FC 2015-20	15th FC 2021-26
Income Distance	62.5	50	47.5	50	45
Population (1971 Census)	10	25	25	17.5	-
Population (2011 Census)	-	-	-	10	15
Area	7.5	10	10	15	15
Forest cover	-	-	-	7.5	-
Forest and ecology	-	-	-	-	10
Infrastructure index	7.5	-	-	-	-
Fiscal discipline	7.5	7.5	17.5	-	-
Demographic performance	-	-	-	-	12.5
Tax effort	5	7.5	-	-	2.5
Total	100	100	100	100	100

*expanded in the next page

PRINCIPLE OF EQUITY

The principle of equity in the devolution of taxes is a key component of fiscal federalism, ensuring that poorer and less developed states receive a larger share of central taxes to help reduce regional inequalities.

In India, this principle has been implemented through the recommendations of the Finance Commission, which determines how the central government's tax revenue is distributed between the Union and the states.

The aim is to ensure that states with limited financial resources and greater developmental challenges are provided with adequate funds to meet the needs of their population.

The Finance Commission evaluates various factors to determine the fair allocation of funds, such as population size, income levels, fiscal capacity, and backwardness. States with lower per capita income or those facing geographical difficulties, like hilly terrain or lack of infrastructure, receive a higher share of central funds to overcome their developmental challenges. This approach is based on the idea that fiscal transfers from the central government should help lift poorer states to a level where they can provide basic services and stimulate economic growth.

Historically, this system was implemented to address the economic disparities between states that had more resources (such as industrialised states) and those that were economically weaker. The intention was to foster national integration and ensure that no region was left behind in the country's development.

However, while the principle of equity benefits poorer states, it also raises several issues. Wealthier states often feel disadvantaged as they contribute a larger share of tax revenues to the central pool but receive relatively fewer funds in return. This can create dissatisfaction among these states, as they believe their fiscal efforts are not being fully recognised or rewarded. .

Criteria	11th FC 2000-05	12th FC 2005-10	13th FC 2010-15	14th FC 2015-20	15th FC 2021-26
Income Distance	62.5	50	47.5	50	45
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Tax effort	5	7.5	-	-	2.5
Total	100	100	100	100	100

Additionally, relying heavily on central transfers can undermine the incentive for fiscal discipline in poorer states, leading to dependency on these transfers instead of developing local sources of revenue and improving governance

FINANCE COMMISSION

Role/Responsibilities of the Finance Commission:

- The Finance Commission recommends the distribution of the net proceeds of taxes between the Centre and the States. It decides the share of states in the central pool of taxes and allocates it among states based on various criteria such as population, income, distance, area, and forest cover.
- The Commission recommends grants-in-aid to the states under Article 275 of the Constitution to address fiscal disparities. These grants help states maintain basic services, meet specific needs, or address natural disasters.
- Addressing Vertical and Horizontal Imbalances. Vertical Imbalance means that the centre collects a major share, but the states have a higher expenditure responsibility. Horizontal meaning allocating funds on the basis of conditions and the deficit of states.
- Measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State, based on the recommendations made by the Finance Commission of the State.
- The Commission accounts for the special needs of certain states, especially those with strategic importance or geographical disadvantages like hilly regions or coastal vulnerabilities.

IMPORTANCE OF THE FINANCE COMMISSION:

- Grants-in-Aid recommendations help the states to meet Disaster Relief and Emergency funding. It also helps them meet their Revenue Deficits and Surpluses.
- Addresses state-specific needs by keeping in mind geographical disadvantages like hilly or coastal regions, or those prone to natural disasters.
- The Commission accounts for the special needs of certain states, especially those with strategic importance or geographical disadvantages like hilly regions or coastal vulnerabilities.
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Constitutionality: An independent and authoritative institution to manage fiscal federalism.

- **Article 280** – Establishment and Composition: The President is mandated to hold the Finance Commission every 5 years or earlier.

- Article 275 – Grants-in-Aid: Providing statutory grants as recommended by the commission to states in need of the hour.
- Article 281 – Recommendations of Finance Commission: The President presents the recommendations of the commission in front of both houses for maintaining transparency and parliamentary oversight.

PARAMETERS INFLUENCING DEVOLUTION

INCOME DISTANCE

'Income distance' is the distance of a State's income from the State with the highest per capita income. Income distance is calculated as the difference between the per capita income of a given state and that of the state with the highest per capita income. States with lower per capita income would be given a higher share to maintain equity among States.

It ensures equitable distribution of funds to reduce disparities in development and resources among states.

States with lower per capita income (indicating a greater income distance from the richest state) receive more funds to help bridge the economic gap.

States with lower incomes often face challenges like weaker infrastructure, fewer investments, and poorer access to services. Higher devolution of funds based on income distance enables these states to improve basic infrastructure, healthcare, education, and other services, fostering balanced regional development.

TAX EFFORT

Tax effort is calculated as the ratio of actual tax revenue collected by a state to its taxable capacity (the potential tax revenue based on the state's economy and population). It reflects how well a state is using its ability to collect taxes. States that exhibit a higher tax effort may be rewarded with more funds during devolution to incentivise fiscal discipline and efficiency in tax collection. Tax effort ensures that states with similar economic capacities but varying levels of tax collection are treated fairly in the allocation of resources. Including tax effort in the devolution formula creates accountability for states to actively improve their tax administration, expand the tax base, and reduce tax evasion.

Tax effort must be balanced with other factors like income and distance to ensure that poorer states are not penalised for having a smaller taxable capacity. It affects the devolution of funds by rewarding states for their fiscal responsibility and promoting efficient revenue generation.

POPULATION

Population plays a crucial role in determining tax devolution, as it directly impacts the formula used by governments to allocate tax revenues among different regions or states. In many countries, population size is a significant criterion in the distribution process, ensuring that more populous regions receive a larger share of tax revenues to meet their greater public service expenditure.

For example, in India, the Finance Commission uses a formula where population weight is a key factor in deciding state allocations. This is because states with larger populations have greater fiscal needs, including infrastructure, healthcare, and education. However, this approach can create tensions because states with high population growth rates may benefit more, potentially discouraging population control measures, while states with stabilised populations might feel their efforts backfire. Hence, while population is a major factor in decision making, great care needs to be practised so as not to disincentivise population-stabilisation measures.

AREA

Area also plays a significant role in tax devolution as it shows the geographical size and the consequent administrative challenges a region faces in providing services. Larger areas will require higher expenditures for infrastructure development, developing transportation networks, and delivering public services because of a scattered population and uneven terrains. Due to this, many governments include the area as a criterion in the tax devolution formula.

In India, the Finance Commission assigns a weight to a state's area in its tax devolution calculations. However, while area is a relevant factor, it often carries less weight than population, as the population directly correlates with the number of people benefiting from public services.

Including the area in tax devolution helps promote equity for the fiscal challenges of large states, ensuring that their size does not become a barrier to development.

The below table highlights the changes made in the interstate tax distribution of states. Over 15 recommendations have been made for various changes, highlighting changing philosophies over the years.

In the beginning, the focus was primarily on the population. However, in order to ensure equitable growth, the fourth commission recommended economic backwardness as a criterion. The seventh commission was the first to recommend a more complex formula. There onwards, income distance has been the major factor, with ecology and tax efforts being considered by some as well. Ultimately, various ideas resurface in different recommendations as mentioned in the Finance Commission's reports.

DEVOLUTION OF FUNDS

No.	Vertical	Horizontal
1	55% of Income Tax40 % of tax proceeds on 3 commodities	80% Population 20% Contribution
2	60% of States1% UTS25% of the tax proceeds on 8 commodities	90% Population 10% Collection
3	66.67% of Income Tax20% of tax proceeds, 35 commodities	80% Population20% Contribution
4	75% of States 2.50% UTS	80% Population 20% Economic Backwardness
5	75	90% Population 10% Collection
6	80	90% Population 10% Collection
7	85	25% Population 25% Inverse of SGDP 25% Poverty Ratio 25% Revenue Equalisation Formula
8	85	22.50% Population 22.50% Inverse Per Capita Income * Population 45% Income Distance 10% Contribution
9	85	10% Contribution 45% Income Distance 22.50% Population 11.25% Inverse Per Capita Income * Population 11.25% Index of Backwardness
10	77.50	20% Population 60% Income Distance 5% Area 5% Index of Infrastructure10% Tax Effort
11	29.50	10% Population 62.50% Income Distance 7.50% Area 7.50% Index of Infrastructure 7.50% Fiscal Discipline 5% Tax Effort
12	30.50	25% Population 50% Income Distance 10% Area 7.50% Fiscal Discipline7.50% Tax Effort
13	32	25% Population 47.50% Fiscal Capacity/Income Distance 10% Area 17.50% Fiscal Discipline
14	42	17.50% Population (1971) 10% Population (2011)50% Fiscal Capacity/Income Distance 15% Area 7.50% Forest Cover
15	41	Income distance: 45%Population: 15% Area: 15% Forest and Ecology: 10% Demographic performance: 12.5% Tax effort: 2.5%



REGRESSION ANALYSIS

Assessing the Effectiveness of Fund Devolution

Objective and Methodology

This section aims to assess whether the existing system of per capita fund devolution across Indian states is effective in achieving developmental goals. The central question is whether states that receive higher per capita funds also demonstrate better economic and social outcomes. If such relationships are found to be positive and statistically significant, it would suggest that the current allocation framework is aligned with development effectiveness.

To test this, a series of state-wise linear regressions were conducted using:

1. **Independent Variable:**

2. Per Capita Fund Devolution

3. **Dependent Variables:**

4. Per Capita NSDP (economic performance)

5. HDI Index (human development)

6. Education Index (human capital formation)

Each regression result was interpreted using the **correlation coefficient (R)** and the **p-value**.

This heatmap visualises the regression analysis between **NSDP per capita** and the **devolution of funds** across Indian states.

- States shaded green indicate a positive alignment, where higher NSDP per capita correlates with higher fund devolution.
- Red regions reflect disparities, where fund allocation is not proportionate to economic output.
- Yellow or unshaded states suggest a neutral or mixed relationship.

Overall, the map reveals inconsistencies in fund distribution relative to state-level economic performance.

States with Statistically Significant Relationships

Only a subset of the 28 states exhibited statistically significant and positive correlations between per capita fund devolution and one or more development indicators. These results indicate that in certain cases, higher funding allocations may be effectively supporting development outcomes.

- **Tripura:** A strong and statistically significant relationship between fund devolution and Per Capita NSDP ($R \approx 0.60$, $p < 0.05$), suggesting a possible link between central transfers and economic performance.
- **Uttar Pradesh:** Significant positive association with NSDP ($R \approx 0.57$, $p = 0.014$), noteworthy given its size and socio-economic challenges.
- **West Bengal and Maharashtra:** Moderate but significant relationships between devolution and NSDP, with R-values around 0.51.



- **Sikkim:** The only state showing a significant association between devolution and HDI ($R \approx 0.51$, $p = 0.032$), suggesting a possible link with multidimensional development.

Key Insight: These cases reflect that in certain contexts, the fund devolution system may be functioning as intended, supporting or incentivising better outcomes.

States Without Observable Patterns

In contrast, a majority of states do not show statistically significant relationships between fund devolution and any of the three indicators. Notably:

1. **Kerala, Tamil Nadu, and Punjab:** Despite consistently high HDI and education scores, these states exhibit no clear relationship with fund devolution, implying that performance is not strongly linked to the volume of central transfers.
2. **Northeastern and smaller states** such as Nagaland, Mizoram, Manipur, and Meghalaya similarly show no significant results. This could reflect:
 - Allocation based on fixed entitlements or administrative categories
 - Differences in governance capacity or absorptive potential
 - Influence of non-performance-related factors in fund allocation (e.g., security needs, geographic considerations)

Observation: The absence of significance in these states indicates that either fund utilisation is highly variable or allocation itself is not systematically aligned with developmental performance.

Comparative Role of Indicators

Among the three indicators tested:

- Per Capita NSDP showed the strongest and most frequent associations with fund devolution.
- HDI and Education Index were significant in only a few states, suggesting that human development metrics are not consistently linked to the allocation of funds.

This indicates that while economic performance might play a role in determining fund flows in some cases, human development outcomes are not a key factor in the current system, at least statistically.

Interpretation and Implications

The overall results offer a mixed evaluation of India's fund devolution framework:

- On one hand, the presence of statistically significant relationships in a few key states suggests that performance-based allocation may be working in isolated contexts.
- On the other hand, the absence of consistent or widespread significance across most states implies that the **devolution system is not uniformly outcome-driven.**

This raises important policy implications:

- If the aim is to support **balanced regional development**, the current mechanism may require adjustment.
- There may be merit in **incorporating performance-linked** incentives — especially for HDI and education — into the Finance Commission's formula.

Conclusion

This regression analysis highlights that higher fund devolution does not consistently correlate with better developmental outcomes across Indian states. While a few examples suggest a positive relationship between funding and economic performance, these are not representative of the broader sample.

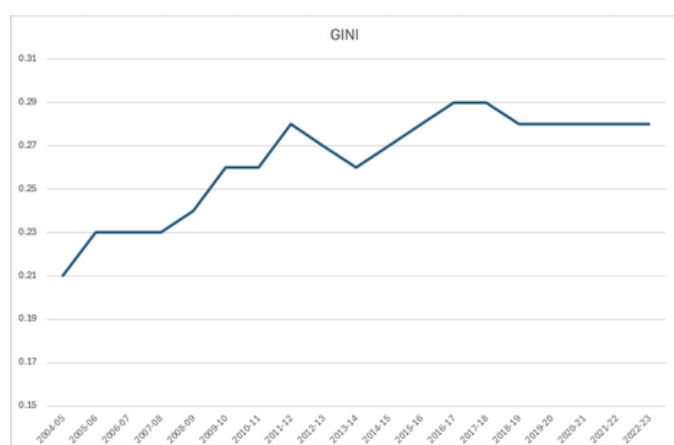
The findings underscore the need for a more targeted and responsive fiscal transfer system, one that accounts not only for needs and population but also for development efficiency, outcome tracking, and governance capacity.



GINI COEFFICIENT ANALYSIS

GINI COEFFICIENT ANALYSIS

The Gini coefficient, a commonly used inequality measure, has been remarkably consistent in India during the past two decades when calculated on the basis of per capita NSDP by state. The coefficients are between 0.21 and 0.29, which reflects a persistent but moderate interstate income inequality.



Analysis of Gini Coefficient Across Indian States (2004–05 to 2022–23)

Between 2004–05 and 2008–09, the Gini coefficient increased moderately from 0.21 to 0.24, indicating a gentle divergence.

This corresponded with high national GDP growth, but benefits seem to have been distributed disproportionately, perhaps favouring more developed states with improved infrastructure and service-oriented economies.

Between 2009–10 and 2011–12, the Gini coefficient rose more steeply, reaching 0.28. This was the time when the spillover effects of the global financial crisis were felt, when economically more powerful states were perhaps more robust or faster to bounce back, increasing the gap of development gap with poorer states.

In an interesting twist, 2012–13 to 2014–15 experienced a marginal decline and stabilisation in the index (~0.26–0.27), potentially due to the effects of welfare schemes such as MGNREGA, higher fiscal transfers, and rural development initiatives intended to reduce regional disparities.

Since 2015–16, the Gini coefficient has oscillated between 0.28–0.29, indicating the plateauing of inter-state inequality. This implies that although the per capita incomes at the state level keep increasing, the percentage income differences have neither increased nor decreased. This pattern reflects the structural persistence of inequality, with fairly more affluent states still leading other states in growth, even after policy interventions.

Interestingly, the period of the COVID-19 pandemic (2020–21 onwards) did not induce a discernible jump or fall in the Gini coefficient. This may be interpreted as indicating that the pandemic hit all states relatively proportionally, or that data on available NSDP averaged out short-run fluctuations.

Conclusion:

The data captures a widely consistent and gradually changing trend of Indian inter-state economic disparity. Although the Gini coefficient has increased from 0.21 to 0.28 over 19 years, in recent years it has stabilised, pointing towards India's robustness as an equal and rigidly organised regional economic system.

This plateau poses critical questions to policymakers: Are redistributive efforts today adequate? Are investments in behind-the-states resulting in long-term convergence? A Gini of ~0.28 is not evidence of extreme inequality, but it is evidence of a persistent developmental divide — one that, if left unaddressed, could stall inclusive national growth.

India's future economic planning needs to move beyond overall growth and aim at empowering poor states through focused investment, infrastructure creation, and education-led human capital development. Only then can the interstate gap really close, making growth both more rapid and equitable.

For Detailed Calculations of the Gini Coefficient, kindly refer to the linked Google Sheet:

[GINI Coefficient](#)

Conclusion

This study set out to evaluate the structure, rationale, and effectiveness of India's fiscal devolution system, with a specific focus on the horizontal distribution of funds among states. Anchored in constitutional mandates and shaped by successive Finance Commissions, the process of tax devolution is intended to balance fiscal needs, incentivise performance, and promote regional equity. However, both historical patterns and contemporary empirical evidence suggest that this intent is only partially fulfilled.

The regression analysis, which tested the relationship between per capita fund allocation and development outcomes, revealed that while some states demonstrate a statistically significant and positive correlation, particularly in economic indicators like NSDP, such results are limited in number and distribution. Most states, including those with high human development achievements, do not exhibit any strong relationship between fund inflows and measurable developmental progress. Similarly, the Gini coefficient analysis highlights a persistent yet moderately stable level of interstate economic inequality over the past two decades, with only marginal improvements during specific policy-driven phases. This suggests that while redistributive efforts have curbed the widening of disparities, they have not been sufficient to engineer meaningful convergence.

Taken together, these findings raise important policy considerations. The current framework, while grounded in equity and need, may require refinement to more effectively link fiscal transfers with measurable outcomes. Incorporating performance-sensitive components, such as improvements in HDI, education, or infrastructure, can strengthen accountability and ensure that resource distribution aligns with national development priorities.

Furthermore, ensuring fiscal autonomy for states while also encouraging efficient utilisation of devolved funds will be key to achieving a more balanced and inclusive federal economic system.

Ultimately, for India to bridge its regional development gaps and realise the full potential of cooperative federalism, its devolution system must evolve from being a formulaic distribution mechanism to a dynamic tool for enabling targeted, responsive, and equitable growth.

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CONTRIBUTORS

Niepun Singal
Soniya Yadav
Smriti A L
Aashray Zutshi
Daksh Soni
Dhruv Gupta
Harshit Sharma
Hiranya Jain
Rachit Jain
Sanchit Mehta

Angel Gupta
Shreya Kejriwal
Siya Hemnani
Vaanchhit Agarwal
Jenice Srivastav